How to Avoid the Worst Sector Mutual Funds

Question: Why are there so many mutual funds?

Answer: mutual fund providers tend to make lots of money on each fund so they create more products to sell.

Learn more about the best fundamental research

The large number of mutual funds has little to do with serving your best interests. More reliable & proprietary fundamental data, proven in The Journal of Financial Economics, drives our research and analysis of fund holdings and provides investors with a new source of alpha. We leverage this data to identify three red flags you can use to avoid the worst mutual funds:

1. Inadequate Liquidity

This issue is the easiest to avoid, and our advice is simple. Avoid all mutual funds with less than $100 million in assets. Low levels of liquidity can lead to a discrepancy between the price of the mutual fund and the underlying value of the securities it holds. Plus, low asset levels tend to mean lower volume in the mutual fund and larger bid-ask spreads.

2. High Fees

Mutual funds should be cheap, but not all of them are. The first step here is to know what is cheap and expensive.

To ensure you are paying at or below average fees, invest only in mutual funds with total annual costs below 1.90%, which is the average total annual costs of the 576 U.S. equity Sector mutual funds we cover. The weighted average is lower at 1.16%, which highlights how investors tend to put their money in mutual funds with low fees.

Figure 1 shows Ivy Delaware Ivy Natural Resources Fund (IGNBX) is the most expensive sector mutual fund and Vanguard Real Estate II Index Fund (VRTPX) is the least expensive. Saratoga (SFPAX, SBMBX, SEPCX) provides three of the most expensive mutual funds while Vanguard (VRTPX, VCSAX, VMIAX, VINAX, VFAIX) mutual funds are among the cheapest.

Figure 1: 5 Most and Least Expensive Sector Mutual Funds

Ticker	Name	Sector	Total Annual Cost
Most Expensive			
IGNBX	Ivy Delaware Ivy Natural Resources Fund	Energy	8.07%
SFPAX	Saratoga Financial Services Portfolio	Financials	6.98%
SBMBX	Saratoga Energy and Basic Materials Portfolio	Energy	6.97%
RYENX	Rydex Series Energy Fund	Energy	5.77%
SEPCX	Saratoga Energy and Basic Materials Portfolio	Energy	5.51%
Least Expensive			
VRTPX	Vanguard Real Estate II Index Fund	Real Estate	0.10%
VCSAX	Vanguard Consumer Staples Index Fund	Consumer Non-cyclicals	0.12%
VMIAX	Vanguard Materials Index Fund	Basic Materials	0.12%
VINAX	Vanguard Industrials Index Fund	Industrials	0.12%
VFAIX	Vanguard Financials Index Fund	Financials	0.12%

Sources: New Constructs, LLC and company filings

Investors need not pay high fees for quality holdings.[1] Vanguard Consumer Staples Index Fund (VCSAX) is the best ranked sector mutual fund in Figure 1 and the top ranked sector mutual fund under coverage. VCSAX's Attractive Portfolio Management rating and 0.12% total annual cost earns it a Very Attractive rating.[2]

On the other hand, Vanguard Real Estate II Index Fund (VRTPX) holds poor stocks and receives our Unattractive rating, yet has low total annual costs of 0.10%. No matter how cheap a mutual fund, if it holds bad stocks, its performance will be bad. The quality of a mutual fund's holdings matters more than its price.

3. Poor Holdings

Avoiding poor holdings is by far the hardest part of avoiding bad mutual funds, but it is also the most important because a mutual fund's performance is determined more by its holdings than its costs. Figure 2 shows the mutual funds within each sector with the worst holdings or portfolio management ratings.

Figure 2: Sector Mutual Funds with the Worst Holdings

Ticker	Name	Sector	Portfolio Management Rating
FMFAX	Fidelity Select Advisor Materials Fund	Basic Materials	Neutral
FDLSX	Fidelity Select Leisure Portfolio	Consumer Cyclicals	Unattractive
FSAVX	Fidelity Select Automotive Portfolio	Consumer Non-cyclicals	Neutral
RYVIX	Rydex Series Energy Services Fund	Energy	Very Unattractive
LMRIX	1919 Financial Services Fund	Financials	Neutral
BHCHX	Baron Health Care Fund	Healthcare	Unattractive
FSDAX	Fidelity Select Defense and Aerospace Portfolio	Industrials	Unattractive
MNRWX	Manning & Napier Real Estate Series	Real Estate	Unattractive
TEFQX	Firsthand Funds Technology Opportunities Fund	Technology	Unattractive
FONMX	Fidelity Disruptive Communications Fund	Telecom Services	Neutral
FIKIX	Fidelity Advisor Utilities Fund	Utilities	Unattractive

Sources: New Constructs, LLC and company filings

Fidelity (FMFAX, FDLSX, FSAVX, FSDAX, FONMX, FIKIX) appears more often than any other providers in Figure 2, which means that it offers the most mutual funds with the worst holdings.

Rydex Series Energy Services Fund (RYVIX) is the worst rated mutual fund in Figure 2. Firsthand Funds Technology Opportunities Fund (TEFQX), Manning & Napier Real Estate Series (MNRWX), Fidelity Select Defense and Aerospace Portfolio (FSDAX), and Fidelity Advisor Utilities Fund (FIKIX) also earn a Very Unattractive predictive overall rating, which means not only do they hold poor stocks, they charge high total annual costs.

Our overall ratings on mutual funds are on our stock ratings of their holdings and the total annual costs of investing in the fund.

The Danger Within

Buying a mutual fund without analyzing its holdings is like buying a stock without analyzing its business and finances. Put another way, research on mutual fund holdings is necessary due diligence because a mutual fund's performance is only as good as its holdings' performance. Don't just take our word for it, see what Barron's says on this matter.

PERFORMANCE OF MUTUAL FUND's HOLDINGs = PERFORMANCE OF MUTUAL FUND

[1] Three independent studies from respected institutions prove the superiority of our data, models, and ratings. Learn more here.
[2] Harvard Business School features the powerful impact of our research automation technology in the case New Constructs: Disrupting Fundamental Analysis with Robo-Analysts.

Analyzing each holding within funds is no small task. Our Robo-Analyst technology enables us to perform this diligence with scale and provide the research needed to fulfill the fiduciary duty of care. More of the biggest names in the financial industry (see At BlackRock, Machines Are Rising Over Managers to Pick Stocks) are now embracing technology to leverage machines in the investment research process. Technology may be the only solution to the dual mandate for research: cut costs and fulfill the fiduciary duty of care. Investors, clients, advisors and analysts deserve the latest in technology to get the diligence required to make prudent investment decisions.

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Disclosure: David Trainer, Kyle Guske II, and Matt Shuler receive no compensation to write about any specific stock, sector, or theme.

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Many firms claim their research is superior, but none of them can prove it with independent studies from highly-respected institutions as we can. Three different papers from both the public and private sectors show:

1. Legacy fundamental datasets suffer from significant inaccuracies, omissions and biases.
2. Only our "novel database" enables investors to overcome these flaws and apply reliable fundamental data in their research.
3. Our proprietary measures of Core Earnings and Earnings Distortion materially improve stock picking and forecasting of profits.

Best Fundamental Data in the World

Forthcoming in The Journal of Financial Economics, a top peer-reviewed journal, Core Earnings: New Data & Evidence proves our Robo-Analyst technology overcomes material shortcomings in legacy firms' data collection processes to provide superior fundamental data, earnings models, and research. More details.

Key quotes from the paper:

- "[New Constructs'] *Total Adjustments* differs significantly from the items identified and excluded from Compustat's adjusted earnings measures. For example… 50% to 70% of the variation in *Total Adjustments* is not explained by *S&P Global's (SPGI) Adjustments* individually." – pp. 14, 1st para.
- "A final source of differences [between New Constructs' and S&P Global's data] is due to data collection oversights…we identified cases where Compustat did not collect information relating to firms' income that is useful in assessing core earnings." – pp. 16, 2nd para.

Superior Models

A top accounting firm features the superiority of our ROIC, NOPAT and Invested Capital research to Capital IQ & Bloomberg's in Getting ROIC Right. See the Appendix for direct comparison details.

Key quotes from the paper:

- "…an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [as New Constructs does] can investors get an accurate calculation of ROIC." – pp. 8, 5th para.
- "The majority of the difference…comes from New Constructs' machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies." – pp. 4, 2nd para.

Superior Stock Ratings

Robo-Analysts' stock ratings outperform those from human analysts as shown in this paper from Indiana's Kelley School of Business. Bloomberg features the paper here.

Key quotes from the paper:

- "the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant." – pp. 6, 3rd para.
- "Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts." – pp. 20, 3rd para.

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